

## Looking for the bubbles



The idea of an economic bubble is not a new idea. The first of the bubbles was the famous "tulip mania" of the 17th century. The good citizens of Holland kept outbidding each other for tulip bulbs, but as soon as a person bought a bulb, he hoped to turn around and sell it for yet more guilders. And the prices, just like real estate prices in the United States up until 2006, just kept going up and up and up. And then, suddenly, without warning, there were no more buyers, just piles of useless tulip bulbs. They could still be planted and would still bloom, but they could no longer be turned into golden guilders. In the years since, there have been many financial bubbles; the most recent bubble, a real estate bubble, burst just a couple of years ago. The real estate bubble was one of the root causes of the current recession.

When a bubble bursts, the pundits and critics standing on the outside, who managed to escape unscathed, make fun of the victims and point fingers at those they blame for causing the crisis. In hindsight, they see clearly all of the signs the fools and commoners missed as they ran like lemmings off a financial cliff and into the sea of bankruptcy. However, those wise pundits never seem to predict in advance the catastrophes they can so accurately describe afterwards. How is it that we all seem to miss the obvious and keep buying stocks, gold, oil futures or real estate when it is clear the prices will peak and drop dramatically? Are we greedy, foolish, and unthinking, or are there other less obvious causes that make it very difficult to predict an economic future?

Anticipating the future is more than a little challenging, in gaming as much as in the stock market. How did the casino owners and city officials in Reno miss the impact of Indian gaming? The last major casino to be built in Reno, the Silver Legacy, opened in 1995. That was nearly seven years after the passage of the National Indian Gaming Regulatory Act, and yet no one anticipated the impact of tribal gaming on Reno. Granted, in 1992, when the planning for the Legacy started, there were few Indian casinos on the west coast - but the beginning of the trend was visible; the first compacts in Washington had been negotiated and "gray" Indian casinos had started to open in California. The Silver Legacy was a joint venture between the two casino companies that occupied the land on either side of it. In hindsight, the land might better have been used for parking and the nearly \$300 million better spent

elsewhere. There are 20 fewer casinos in Reno today than when planning started on the Silver Legacy, and the surviving ones are struggling. How did we miss the obvious?

The same could be said about many jurisdictions. When gaming started to expand past Nevada and New Jersey, no one gave much thought to Indian casinos or even to neighboring states. Instead each new jurisdiction worried more about the mafia than competition. In most cases, that means there is too much regulation, too much taxation and too many casinos for the existing markets; and each new jurisdiction shrinks the size of the existing markets. The jurisdiction faced with the most competition from outside is New Jersey. For most of the era of legalized gambling, Atlantic City was the unchallenged master of east coast casino gambling. That is no longer true; it is not true for Atlantic City or any other casino jurisdiction in the nation.

What if we could have foreseen the progress of gaming expansion in the United States? What could we or would we have done? Seeing the development of a bubble or predicting a crisis at the end of a trend is difficult, and constructing a coping strategy is equally challenging. With foresight, the Silver Legacy, Borgata and CityCenter might never have been built; or they might have been smaller. With foresight gaming companies might have formed partnerships to bid on casinos in new jurisdictions, allowing them to capitalize on as many opportunities as possible - but also reducing the risk for each company. Certainly, anyone who had foresight would have avoided all jurisdictions with high tax fees, tax rates and investment requirements - and maybe, if everyone refused to play, the lawmakers in those jurisdictions might have listened to reason. Okay, that is plain foolish. I am not certain what we might have done, but if we always assume conditions are going to change and plan for a long term sustainable business, it might be possible to avoid the disasters that some jurisdictions will (or have) experience(d).

All of the above discussion was by way of introducing China as a future bubble candidate. The Chinese gambling center, Macau, just might be the next gaming bubble. At the moment gaming revenues are growing at an unbelievable pace, mainly due to its proximity to mainland China, but if China allowed casinos on the mainland, Macau would become a historical backwater. Currently, casino gaming in China is limited to Macau, but other forms of gambling in China are expanding. This month horse racing was reintroduced; earlier this summer, sports betting was also authorized, and lottery sales were \$15.6 billion for the first six months of 2011, a 31 percent increase.

The Chinese are legendary gamblers; gaming revenue in Macau is expected to hit \$32 billion in 2011 and the majority of the gamblers are Chinese from mainland China. The most recent revenue numbers for August 2011 indicate a growth of 57 percent in gaming revenues year over year to \$3 billion. The gaming revenues from China are almost beyond belief - the main reason is, of course, the mainland. Macau is the closest casino destination to the 1.6 billion Chinese citizens. The future of gaming in Macau would seem to be golden and unlimited - the Chinese economy is the most robust in the world; personal income is rising at a faster rate in China than it did in the United States during 1950-1980.

Why would I suggest that Macau might be a bubble in the making? To support my case I would cite all of the same statistics that Macau boosters cite to prove the unlimited future for casinos in Macau. But there is another salient fact, and it was what makes Macau truly different from any other gaming jurisdiction in the world - Macau and its casinos are ultimately governed by China. China's government is communist, but its economy is increasingly capitalistic - but not the free market capitalism we tout in the west. It is a controlled economy, however, not controlled in the way communist Russia, Cuba or East Europe were controlled economies. China is unique in all of the nations of the world in the manner in which its economy is regulated and controlled.

In the "old communist" economies the government planned the economy, five years at a time. The process was painful and relatively unsuccessful - mainly because those governments were inflexible and absolutist. China is much more flexible and experimental; China experiments with various capitalistic ideas and industries on a limited scale, allowing foreign

companies to operate in specific locations and under specific conditions. When an idea proves successful and the Chinese government can see clearly how to manage and control it, they open the industry up to more regions of China and to Chinese operators. There are several gambling companies operating in China, operating lotteries, sports betting and horse racing, and most of the gambling is new, introduced this year. China has had a lottery for years and Macau and its casino industry have been under Chinese control for 12 years, but this year the Chinese gambling experiment "upped the ante" considerably by adding sports and horse race betting. The gambling "build-out" process will be slow; the Chinese are patient and will take their time with this experiment.

China also thinks differently about geography. We think in terms of states for most commercial regulation, China thinks in terms of zones or regions artificially created. Macau to us is a state, but to the Chinese it is a special zone and one with flexible boundaries. Beginning this year, China has created a "barrier-free tourism zone" that includes Macau, Hong Kong and Guangdong province, a province with a gross national product of nearly \$700 billion and 104 million people. That would be 104 million people with relatively large individual incomes who can come and go within the zone without restrictions. A bit like moving a casino on the mainland for an experiment, don't you think? China is also experimenting with tourism in other ways. Also beginning this summer, China is allowing Chinese citizens from three cities to travel to Taiwan as individuals, that is, without supervision or control - the target is 10 million Chinese tourists in Taiwan in the first year. Of course, it is expected to be two sided with Taiwanese visiting China in larger numbers - who knows, some day they might be offered dual citizenship?

Each step China takes is a conscious step towards what it sees as its rightful place as the world's number one economy and world leader in all things economic and political. The long-term plan for the Chinese economy is not written - and if it is, it is not shared with people outside of the party leadership. However, some things are obvious. China intends to use the resources of other countries as a temporary measure to stimulate and grow its economy while preparing its citizens to take over - and eventually export - Chinese products and expertise. We are seeing the first instance of that policy in international finance - China now owns the majority of the debt of the United States. In the not so distant past China could barely finance its own needs; today it exports money by buying other countries' bonds. Today China is a very important market for GM and Ford; in ten years America will be an important market for Chinese cars. Most other industries will have a similar tale to tell over the next few years.

In the process of converting its economy from a socialist-communist economy to a capitalistic economy, China is also recreating its national narrative. The national narrative is an important component in the overall scheme of a national existence, and every revolution recreates the narrative consciously. In the United States, for example, after the Civil War it was necessary to create a new national narrative. The revolutionary time was over, as was the western expansion; our government, political, religious and business leaders used the "world's fairs" between 1876 and 1916 to do just that - create a new national narrative of an industrial nation becoming a world leader. In the 21<sup>st</sup> century, China has some other tools it can use - films, television, schools and the print media.

This summer, China held back the opening of *Harry Potter*, *the Transformers* and the other summer blockbusters from Hollywood until its own "big-budget epic" got its share of the ticket sales, leaving *The Beginning of the Great Revival* virtually unchallenged at the box offices. The film is the second in an epic retelling of the history of modern China and the communist party; the second chapter tells the story of the founding of the party beginning in 1921. The government spent a great deal of money on the film and wants the Chinese people to see it without being diverted. The *Chinese Global Times* says the Chinese government does not look at films as simply commercial entertainment ventures, but sees them as basic forces in shaping public opinion. This film is more than propaganda; it is more a celebration of China, today's China, a country getting ready to take its natural place as an economic power.

The film is typical of China's long-term plan. China is not a controlled society and economy so much as it is managed. We have no mechanism for managing society or the economy -

regulating, yes, but not managing - so we are not good at understanding or even seeing the process as it unfolds. The Chinese are trying to create a freer, but not completely free, market. The government keeps a close eye on things and steps in to prevent a crisis rather than in reaction to one. For example, personal income and the ensuing consumer spending are rising at a dramatic rate, and so are the prices of some things, just as they rise in any country with a growing economy. Those price increases include real estate - more and more people can afford houses in China, and they are buying them. That boosts construction of new houses, but it also creates a market for secondary sales and speculation - the buying and flipping that became very famous here in the heady days before the bubble burst and the recession arrived. A number of editorials on the Chinese real estate market by westerners have been predicting, with absolute certainty, a crash in Chinese real estate.

Possibly the officials that make up the Chinese government read those editorials, but maybe not; in either case the government has recently instituted some price controls and the *Chinese People's Daily* is reporting success of the program, stating that in some regions prices have stabilized and even dropped slightly. The government now plans on expanding the program. That is characteristic of the Chinese government, to test social and economic programs in limited areas or under limited circumstances and then, if the program works, to expand it.

Back to Macau. In the years since China assumed administrative control over the former Portuguese colony, the government has watched it closely and introduced a number of measures to control the growth of the casinos and to limit the traffic from the mainland, and now it is expanding gambling to the mainland by allowing at least one province free access to Macau. Don't expect this to be the end of the line; this too will be an experiment. In the meantime other forms of gambling will continue to expand on the mainland.

So what is my bottom line? There is no great concern for the moment - China is very cautious and moves very slowly. I rather image that the casinos in Macau are in a situation that is analogous to the one which the casinos in Reno faced in 1975 or the Atlantic City casinos in 1985. Things will be fine for a few years, probably better than fine. In both Reno and Atlantic City, there were 15 years of growth and record profits before the hint of disaster was in the air. The first test for the casino operators in Macau will come with the license renewals. Beginning in 2020, the exiting casinos will need to have their licenses renewed. Some licensees may find Chinese companies bidding to replace them. I think it is very likely that at least half of the licenses will be granted to Chinese companies. Certainly, the majority of the financing for casinos in Macau will be done by Chinese banks, not western banks or stock markets. But I suspect by then, there will have been further expansion of gambling options on the mainland and possibly even one more "special zone" where casinos are allowed. I believe that the Chinese government's long-term objective is to have all industries in China operated by Chinese citizens.

How should we act when we know a bubble is impending? That depends on how far away it is - and that is the gamble, isn't it? Every time you buy a tulip, you are wagering there is still one more tulip buyer out there. Every dollar invested in Macau by American companies is making that same wager. There is still enough time to profit from that investment. Ladies and gentlemen, step up. Place your bets. Watch the spinning wheel; round and round it goes, and where it stops, no one knows.

But then, that is just my opinion, isn't it?

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